

1 **MR. ALTON HARRIS, ATTORNEY AND EXPERT ON SECURITIES AND FUTURES**
2 **REGULATION**

3
4 CHAIRMAN JAMES: Mr. Harris.

5 MR. HARRIS: Thank you very much. I'm very pleased
6 to have the opportunity to appear before you this morning. While
7 Professor Ruder is bold enough to offer recommendations to you as
8 to the parallels or lessons to be taken from the securities laws,
9 I'm not nearly as brave as he is. So I omit any recommendations.
10 But I hope that my remarks will provide some illumination as to
11 areas in which one might look, were one to be interested in
12 regulatory patterns that might be applicable.

13 I also want to cover not only the securities areas,
14 but the futures areas which Commissioner Leone referred to. We
15 often confuse, I think, those people that are not actively
16 involved in the financial markets, the securities areas with the
17 commodities areas. But I think it's very important to clearly
18 distinguish between them. As Professor Ruder pointed out, in the
19 securities area one is buying something. That is, when one buys
20 a stock or a bond or even a derivative security, one is buying an
21 interest in something. It is an intangible interest.
22 Nonetheless, it is an interest in something, generally referred
23 to as an interest in the issuer, a corporation or another type of
24 business.

25 In the commodities area, one is simply entering into
26 a contract with another party. Generally that other party
27 happens to be a clearing corporation that is an entity that
28 facilitates the trading between participants in the markets but
29 one's interest in that case is simply a contractual commitment to

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1 receive whatever the benefit of that bargain is. There is no
2 investment. It is simply a contract. That contract indeed is not
3 so dissimilar from the kind of contract that one has when one
4 gambles.

5 When one gambles, one enters into a contract with
6 someone that if seven turns up on a pair of dice the first time
7 you roll, you will be paid. In the commodities area, the
8 contract is that if a particular price is achieved with respect
9 to a particular underlying entity, whether that's corn or United
10 States treasury bonds or virtually anything else, electricity
11 rates, catastrophe insurance coverage, that one will pay you the
12 difference or you will pay that other person the difference.

13 Indeed the similarities between the commodities
14 markets and gambling are so close that in the statute regulating
15 the commodities markets there is a specific provision pre-empting
16 state law. That provision is in the commodities law because of a
17 concern that under state gaming statutes, commodities activities
18 would literally fall under and be precisely covered by state
19 provisions on gaming. So we have in this federal statute
20 regulating the commodities industry a pre-emption of state laws
21 to be certain that no one can outlaw that activity on the ground
22 that it is gambling.

23 Now, the counterpart of that is that when contracts
24 are permitted to be traded pursuant to this pre-emptive
25 authority, they must be approved by a federal regulatory
26 commission, in this case the Commodities and Exchange Commission.
27 In order for the Commodities Futures Trading Commission to
28 approve a contract, they must find that it has economic value.
29 They must find that it serves some kind of an economic purpose.

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1 That again, is out of a recognition that one could have futures
2 trading on anything. One could have futures trading on the NBA
3 playoffs. That hasn't been approved and it wouldn't be approved
4 because it wouldn't meet the economic test.

5 But the point I want to make is simply that there is
6 no functional difference between the nature of the contracts that
7 are being traded in the commodities market and the nature of the
8 contracts that could be traded or entered into in a gambling
9 situation. Only in one case there is a federal Commission that
10 says those contracts to be pre-empted from state law need to
11 serve an economic purpose, they have to be valuable.

12 How are they valuable? They're valuable to farmers
13 to hedge. They're valuable to financial institutions in order to
14 hedge. They're valuable to people who want to protect their
15 delivery. So in fact, there are key fundamental underlying
16 values associated with commodities contracts that may not be
17 associated with gambling contracts. The point again is that in
18 structure, those are the same things.

19 Whether we're dealing with securities or these
20 commodities, there are essentially three kinds of regulatory
21 techniques that the SEC with respect to securities, the CFTC with
22 respect to commodity contracts have come up with. Those three
23 are those that Professor Ruder has indicated and I have tried to
24 identify for you in my presentation.

25 The first is disclosure. And as I try to point out,
26 disclosure in both of these markets, in the securities markets
27 and the commodities markets, is of two types. One type is the
28 type that Professor Ruder mentioned. That is, if you're going to
29 sell securities or if you're going to sell a vehicle that's going

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1 to invest in commodities, you have to tell the particular risks
2 of the particular product that you're selling.

3 But there are also other kinds of disclosures that
4 are used in both the securities and the commodities area. These
5 I've called generic disclosures. The generic disclosures are, in
6 the option area, they relate to this option disclosure document
7 again that I included here and David Ruder called your attention
8 to. It's a very complex lengthy document. There is also, in the
9 SEC area, there is a class of security that is referred to as
10 penny stocks. These are stocks that typically sell for less than
11 five dollars a share; they are not traded on a stock exchange or
12 in the NASDAQ market and the SEC has come up with a generic risk
13 disclosure statement that must be given to any person who is
14 about to buy such a stock. The broker must deliver this
15 governmentally prescribed document, and that document is in
16 exhibit B in my testimony.

17 On the futures side, anyone opening a futures
18 account, that is, anyone who is going to trade futures or options
19 on futures, that is, anyone that is going to invest in the
20 commodities market must be given a governmentally written,
21 governmentally prescribed risk disclosure statement. That
22 statement is included in exhibit C. And so forth and so on with
23 respect to other kinds of activities that one engages in. The
24 government in both of these areas has seen fit not only to tell
25 people that they must disclose risks, but has decided that it's
26 going to write what the disclosure is going to have to be.

27 Most interesting of those disclosures is the penny
28 stock disclosure. Let me just read part of what the government
29 tells a broker he must give to his customer before he can sell

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1 the penny stocks. "Penny stocks can be very risky. You may lose
2 your investment. Be cautious of newly issued penny stocks. Your
3 sales person is not an impartial advisor. Do not rely on the
4 sales person, but seek outside advice before you buy any stock."

5 You've got to give the investor that before you can
6 tell him he ought to buy this junk.

7 Apart from disclosure, the SEC and the CFTC has said
8 for certain people we don't think they need that kind of
9 protection. For certain classes of people you don't have to
10 receive all of those warnings. There are then a whole category
11 in both the securities and commodities area of people who are
12 exempt from certain regulatory requirements. I won't go through
13 all of them. David Ruder has mentioned accredited investors.
14 But on the securities side we have a whole plethora of initialed
15 categories, qualified institutional buyers, qualified purchasers
16 as well as accredited investors. We have similar categories on
17 the commodities side, qualified eligible participants, qualified
18 eligible clients, eligible slot participants. All of those
19 people are supposedly sophisticated and therefore, exempt from
20 these disclosure obligations.

21 Finally, there is this residual category that again
22 Professor Ruder mentioned and that's suitability. That's really
23 saying even though we've given people all the disclosure in the
24 world or we've avoided giving them disclosure because they're
25 purportedly so sophisticated, nevertheless there is still some
26 responsibility on the part of those that sell these interests to
27 people to be certain that those interests are appropriate for
28 them or suitable. On the securities side, that's well
29 established. It's called the suitability requirement and it's

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1 strictly enforced. On the commodities side, there is no such
2 strict suitability standard. But I want to close only by quoting
3 from a very famous opinion of the Commodities Exchange Commission
4 in which they said, "in analyzing the reliance element in
5 traditional fraud cases," -- we can call this over-reaching or
6 breaching fiduciary duty -- "it has long been recognized that
7 people who are exceptionally gullible, superstitious, ignorant,
8 stupid, dimwitted or illiterate have been allowed to recover when
9 the defendant knew it and deliberately took advantage of it."

10 Thank you very much.

11 CHAIRMAN JAMES: Thank you, both. It was both
12 fascinating and very enlightening.

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